Board involvement in strategy and organisational performance

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In firms where oversight by a regulatory body within the industry exists and where new core competencies must be developed to offset aggressive competition, there is evidence that a larger role for board of director involvement in strategic activities occurs. Within this context, survey data from board members and CEOs reveal that in organisations where financial soundness scores are less favourable, the odds of the board being more involved in a formal strategic planning process increase. Regarding a strategy role that consists of the board collaborating with management in making new strategic decisions, it is less likely that the board will take on this role when the organisation's financial soundness scores are not at the optimal level.

For many years, boards of directors have been encouraged in theory and in practice to take on an active strategy role. However, in much of the literature the nature and extent of board involvement in strategy is undifferentiated. Most empirical studies dealing with corporate governance issues focus on board composition and structure variables and do not examine the level of involvement from a decision making perspective. Capturing this particular perspective is not only of interest to researchers but also is of practical importance, as general management seeks to realise the board's full potential in the strategic arena.

This paper reports on the involvement of boards in a five-step strategic planning process and also examines board participation relative to that of senior management in strategic decision-making and evaluation. The first section examines the limited empirical findings of board involvement in strategic activities and outlines three viewpoints on possible participation levels. The paper then describes an empirical study that shows board involvement varies in relation to the organisation's financial performance.

Background

Boards of directors, in general, have been studied at great length to determine their contribution to organisational performance. However, most of the empirical studies rely on composition and structure variables, such as board size, outsider and minority representation, and committee structures, even when attempting to understand board processes. The reason for choosing variables from secondary and archival sources is because of the difficulty in gaining access to directors and senior management (Pye and Camm, 2001). As a result, the number of empirical studies that directly assess board involvement is limited. In those few studies where boards and top management respond to queries about the nature of board participation, findings reveal low to mid-levels of board involvement in strategy.

For example, two studies from the 1980s report that the board's role in the strategic planning process consists of the directors advising management on decisions but not directly involved in the strategy process (Henke, 1986; Tashakori and Boulton, 1983). In another study, although directors express a desire to be more strategic, their participation in formulating strategy is low, with the nature and extent of board involvement determined primarily by the chair, which in many organisations is the CEO (O'Neal and Thomas, 1996).

In an empirical study where survey questions deal with the board's involvement in strategic decision-making relative to management, CEO and director respondents report that boards are more involved in the strategy development stage, revising, ratifying and working with management to develop strategic direction. A smaller percentage of boards are involved in the evaluation of prior strategic decisions, but this is not as prevalent as board involvement in making new strategic decisions. This study also reveals a positive relationship between financial performance of an organisation and board involvement in strategic decision-making (Judge and Zeithaml, 1992).

On the basis of these studies, along with the theoretical and practitioner writings about the board's strategy role, the extent of board involvement can be viewed from three levels. The lowest level of involvement stems from a traditionalist viewpoint, which gives responsibility to boards for corporate leadership without interference in day-to-day operations. Proponents of this viewpoint categorise the board's role as service in representing the shareholders and as control in protecting their interests by monitoring management decisions (Fama, 1980; Fama and Jensen, 1983). Within this framework, developing strategy is considered the domain of senior management, and board activities are primarily to review CEO analyses, provide counsel or advice, and ratify senior management decisions.

A second school of thought assigns the board a more active role in the form of strategy review. According to this viewpoint, directors do not develop new strategies, but they do contribute to the process by suggesting refinements of strategic plans, by probing management's assumptions about the organisation and its environment, and by reviewing issues dealing with the process of implementing the plans (Pfeffer and Salancik, 1978).

The highest level of involvement is when boards take on a strategy role in collaboration with senior management, and board participation goes beyond the traditionalist and strategy review levels. The collaborative approach advocates a partnership between senior management and the board in mapping the strategic direction of the organisation. Directors may propose ideas for new strategies and may carry out analyses that lead to a revision in existing strategies. In essence, boards are not limited to approving managerial choices but may initiate and develop strategic changes (Millstein, 1995; Zahra, 1990).

Given the various levels of involvement identified in the literature and the limited evidence that board involvement in strategy formulation is associated with organisational performance, this study aims to add to the empirical literature about boards. It addresses the question of whether board involvement in strategy is at the traditional, strategy review, or collaboration level and whether a relationship exists between a board's strategic activities and the organisation's financial performance.

Research methodology

Study site and respondents

In the fiercely competitive United States financial services industry, credit unions hold a unique position and have achieved remarkable growth since the first organisations were established in 1909. With their roots in the German general co-operative movement of the 1840s, United States credit unions are financial service cooperatives that offer savings and loan opportunities for members who have a common bond based on their place of work or the community where they reside.

However, since the late 1990s, competition for members' business has never been stronger. Traditional and internet providers are aggressively pursuing new financial services business with the promise of greater banking convenience and competitive rates. In addition, the political pressure from the banking community to eliminate the tax exempt status afforded to credit unions is expected to continue at various intervals. As a result of the overall environmental climate and the competitive landscape, many – but not all – credit unions have adopted strategic planning processes, and they are aggressively developing new internet banking core competencies. The industry is closely regulated by the United Stated Federal Government's National Credit Union Administration (NCUA), which monitors and rates financial performance.

It is suggested that contextual factors such as regulation within the industry and the commercial requirements of industry competitors to develop new core competencies are likely to affect the role of non-management directors (Pye and Camm, 2003), and this site provides an opportunity to control for these special circumstances.

Recognising the limitation of surveying one set of respondents (either board members or top management) to assess board decision-making (Judge and Zeithaml, 1992), this study questions both chief executive officers and board members regarding the level of board involvement in strategy. Officials from the national offices of New York and Massachusetts credit union associations agreed to assist in the mailing of surveys and to co-sign letters with the researcher outlining the survey's purpose. CEOs from 275 organisations and board members from 179 credit unions responded. When two or more board members replied from a single organisation, their responses were averaged to yield one set of board of director results from each organisation. These responses represent 42% of New York credit unions and 32% of the Massachusetts firms.

Measures

Three sets of questions in the survey provide data about the board's strategy role (Wooldridge and Floyd, 1990; Judge and Zeithaml, 1992). The first set asks about the board's involvement in a five-step strategic planning process: developing a mission statement, reviewing environmental conditions,

identifying long range goals, identifying specific action steps to achieve the mission and goals, and monitoring the implementation of strategic action steps. Respondents note level of agreement regarding board involvement in each activity on a five-point scale, ranging from 1 ('strongly disagree') to 5 ('strongly agree'). The responses for each step of the planning process are averaged to yield one strategic planning score (the strategic planning scales have good internal consistency, with Chronbach's alpha coefficients of 0.81 for the CEO data and 0.90 for the board data).

Using the scale developed by Judge and Zeithaml, the second and third set of strategy questions ask about the board's role as compared to management's role in making new strategic decisions and in evaluating prior strategic decisions. There are seven choices for the strategic decision making measures, and each is anchored with a brief description. For example, for the measure dealing with board involvement in making new strategic decisions, level 3 is described as 'The board usually asks probing questions and then ratifies strategic proposals that are formed primarily by the chief executive officer.' This compares to level 7, which is the highest level of involvement and is described as 'The board usually forms strategic decisions separate from the chief executive officer.'

The same type of anchored scale defines levels for the last strategy question dealing with board involvement in evaluating prior strategic decisions. Level 3 is described as 'the board usually accepts evaluation given by management after asking probing questions.' This compares to level 7, which is the highest level of involvement and is described as 'the board usually collects its own information about the progress of the strategic decisions separate from management.'

The organisational performance variable for the study is an objective measure of credit union financial soundness. The US Government's National Credit Union Administration evaluates credit unions using an algorithm consisting of ratios for capital adequacy, asset quality, earnings, and liquidity management. The combination of these ratios yields a performance score, referred to as a CAEL rating, an acronym representing each ratio included in the formula. The scores range from a very sound rating of 1 (that is, the credit union is sound in almost every respect) to a red flag rating of 5 or more, depending on the number of areas causing concern. Scores of 5, and occasionally greater than 5, indicate a credit union that is basically insolvent and unlikely to survive more than 12 months. Even for those organisations with a rating above 3, NCUA works closely with the organisations to improve the ratings and to ensure long term viability of these financial institutions.

One last measure is included in the study as a control for the effects of prior financial performance. In this industry, organisations with higher CAEL ratings (less favourable) face close scrutiny by the government regulatory body. It is policy for the auditors to mandate that the board and management develop formal strategic plans and operational plans, particularly for firms with troublesome CAEL ratings. As a result, average CAEL ratings for the previous three years are included in the statistical design to ensure that any association between board involvement and organisational performance is not due to the firm's prior performance.

Results

A comparison of CEO and board member ratings shows a statistically significant difference between the responses of these two groups of raters. That is, CEOs consistently rate their board's involvement lower than board member ratings. Table 1 presents the means and standard deviations of the measures in the study. Standard deviations suggest ratings that vary from the mean values; however, the amount of deviation from the means is offset to a large degree by the size of this data set.

The mean ratings reveal that the perceived level of board involvement in the three strategic activity categories varies significantly depending on whether viewed by CEOs or by board members. Regarding the board's involvement in the formal strategic planning process, board members more strongly agree that they are involved in the planning process, which includes developing the organisation's mission, analysing the environment, identifying goals and action plans, and monitoring the implementation of the goals and strategies. On the other hand, CEOs tend to rate board participation in the process at a lower level.

For the strategic decision making measure, CEOs perceive that management develops new strategies and board members ask probing questions that result in changes to new strategies. In contrast, board members view their involvement to be much greater, reflecting a type of partnership with management, where both management and the board participate in forming strategies during board meetings.

Regarding the evaluation of prior strategic decisions, both groups perceive the board's involvement more traditionally, which means they view the role as part of management's domain. CEOs perceive the board as relying on them for information about strategy progress, trusting management to supply comprehensive and accurate evaluations and asking probing questions. Board members perceive their role as one responsible for determining the timing and criteria of the evaluation and occasionally challenging the information supplied by management but still relying on them for information about strategy progress. So while boards rate their involvement higher, the nature of that involvement is along traditional lines.

For the analysis of the relationship between board activities and organisational performance, a stepwise TOBIT model is used. The stepwise approach attempts to find the best regression model and eliminates variables that are not significant. The choice of the TOBIT model is suited to this study's data set, particularly the financial soundness performance score. Although management studies typically regress performance on the independent variables using ordinary least squares (OLS) regression, a major assumption of OLS is that the data approximate a normal distribution.

When this assumption is violated, the OLS model is not recommended because it is likely to produce depressed correlations (Hammer and Landau). In this study, because the financial soundness performance variable has no negative numbers and government oversight results in most of the values falling in the 1 to 3 scoring range, the distribution is essentially truncated. Therefore, the regression analysis is performed using the TOBIT model, which

Table 1: Comparison of CEO and board ratings of board involvement in strategy

Perception of board involvement in strategic activities	Average CEO ratings	Average board ratings
Board involvement in five-step strategic planning process (Average of five planning activities)		
SCALE	3.55	**3.93***
Ranges from 1 = strongly disagree to 5 = strongly agree	(0.90)	(0.94)
	n=275	*n*=180
Board involvement in making new strategic decisions		
SCALE	4.07	**4.71***
1 No involvement	(1.49)	(1.35)
2 Board ratifies proposals formed solely by management	*n*=256	*n*=163
3 Board asks probing questions, then ratifies proposals formed solely by management		
4 Board asks probing questions which lead to revisions of strategic proposals formed by management		
5 Board helps to form strategic decisions with management in board meetings		
6 Board helps to form strategic decisions with management within and between Board meetings		
7 Board usually forms strategic decisions separate from management		
Board involvement in evaluating prior strategic decisions		
SCALE	3.57	**4.39***
1 Board is usually not involved with monitoring progress of prior strategic decisions	(1.37)	(1.51)
2 Board usually accepts the evaluation given to it by management without asking probing questions	*n*=257	*n*=165
3 Board usually accepts evaluation given by management after asking probing questions		
4 Board usually determines the timing and criteria of evaluation, but information is supplied by management and is rarely challenged by the Board		
5 Board usually determines the timing and criteria of evaluation, but information is supplied by management and is often challenged by the Board		
6 Board usually determines the timing and criteria of evaluation, and often requests additional information after receiving the progress report from management		
7 Board usually collects its own information about the progress of the strategic decisions separate from management		

*t test of mean differences indicates board members rated their involvement significantly higher than CEOs, $p < 0.01$.

uses maximum likelihood estimation to allow for data that is truncated (Tobin, 1958).

Because of the statistically significant differences between the perceptions of CEOs and board members shown in Table 1, the data sets are analysed separately. The results of the regression of board involvement in strategic activities on organisational financial performance are shown in Table 2, controlling for past performance. Despite the difference in the average

Table 2: Results of stepwise TOBIT regression for the organisation's financial performance

CAEL Rating (Higher ratings indicate less favourable financial performance)	Standardised β Coefficient	t	sig.	Odds ratio e ^ β	Interpretation
Five-step strategic planning process (level of board involvement) CEO ratings Board member ratings	 0.0617 0.1089	 2.00 2.61	 0.047 0.010	 1.0637 1.1150	As boards are perceived to be more involved in the five-step strategic planning process, the odds of the organisation's CAEL score (financial performance rating) increasing are 1.06 higher (according to CEO ratings) and 1.12 higher (according to board member ratings).
Making new strategic decisions (level of board involvement) CEO ratings Board member ratings	 –0.0485 –0.0836	 –2.62 –2.94	 0.009 0.004	 0.9526 0.9198	As boards are more involved in making new strategic decisions in partnership with management, the odds of the organisation's financial performance rating (CAEL score) increasing are less than 1.0, according to both CEO and board member ratings.

1) e ^ β = odds ratio calculated by taking the exponential of the estimated β's.
2) 'Pseudo R^2' (amount of variance explained in loglinear models):
CEO data: 14.8%
Board member data: 17.6%

ratings between CEOs and board members, both sets of data reveal similar results.

When prior performance is taken into account, according to both CEO and board member perceptions, the nature and extent of the board's strategy role varies as the organisation's CAEL rating increases (indicating poorer financial performance). That is, when boards are perceived to be more involved in formal planning, the odds of the organisation having a higher CAEL rating and thus poorer financial performance are 1.06 greater (based on CEO survey results) and 1.12 greater (based on board member survey results), holding all other variables constant. In contrast, when the board is more involved in making new strategic decisions, the odds of the organisation having higher CAEL scores are less than 1.0 (about 0.95 according to CEO data and 0.92 according to board member data). The third variable representing the board's involvement in evaluating prior strategic decisions is not significant and therefore does not appear in either the CEO or board member analyses.

Conclusions and discussion

For many years, boards of directors have been encouraged in theory and in practice to be involved actively and substantively in issues pertaining to the organisation's corporate strategy. However, few studies examine directly the nature and extent of board involvement. Regarding the nature of the board's strategy role, this study provides information about two aspects of the board's strategic contribution and conditions under which the involvement exists.

First, regarding the board's involvement in the formal five-step strategic planning process, on average, the level of participation is at the mid-range. These results are consistent with practitioner observations that most boards occupy a middle ground when it comes to getting involved in the formal planning process (Oliver, 2000). They are not so deeply involved in setting strategy that they take over the process but they are far more active than the rubber stamp boards that meet only occasionally and simply approve plans without participating in them.

Regarding the second measure of board participation in strategic decision making, CEOs and board members vary in their perception of the board's involvement in making new strategic decisions. In this organisational setting CEOs view their boards as being more reactive, although they acknowledge that boards question the proposals brought to them for review. In contrast, board members view their role as working with management to develop new strategies. When it comes to evaluating prior strategic decisions, both the CEOs and the directors perceive the board's involvement at a traditional level, simply relying on management for information about the organisation's strategy progress. While writers about boards and leadership see directors as independent thinkers who take an active role in shaping the strategic direction of the organisation (Finkelstein and Hambrick; Walsh and Seward, 1990), this study suggests that the board's strategy role relies on top management for leadership, direction, and information.

As to the extent of board involvement and its relationship to organisational performance, board participation levels vary in relation to the organisation's financial standing. When the CAEL ratings for this group of organisations are better, boards tend to be involved with management as partners in making new strategic decisions. As one CEO of a financially strong credit union noted, 'Our directors are viewed as partners in setting the strategic direction of our credit union. No major decisions are made without their involvement.'

When performance is weak, the odds that the board will be involved in a formal strategic planning process are greater. There is preliminary evidence from the study that a different, more structured strategic role for the board exists under these conditions when organisational performance is not strong. Although it is not clear whether greater involvement by boards in strategy is the cause or effect of performance, it appears that an organisation's financial condition can and does influence the board's strategy role.

These findings have implications for senior management. First, when respondents were told that CEO perceptions of board involvement varied from the directors' views, there was little surprise as to the perceived level of involvement from either group. One CEO noted 'Board members expect to

have all decisions made for them and our board is satisfied to simply ratify management proposals.' The contrasting view is described by a board member who commented, 'As part time board members, we are contributing at very high levels. Preparation for meetings and working on the organisation's new strategic goals are very demanding activities.'

Clearly boards and management have different perceptions of the board's expected and actual strategic contribution. These varying perceptions may hinder future efforts by CEOs to increase board participation in strategic-oriented activities. These include attending special meetings to review strategic assumptions, examine data about projected environmental and competitive conditions, and track the success or failure of key initiatives.

Although it is beyond the scope of this study to analyse the implications of the differences between these groups, management should incorporate a discussion of desired versus actual board participation as part of the board development process. Techniques, such as creating a strategic management system designed specifically for board performance evaluation, are available to systematically identify and monitor board performance (Epstein and Roy, 2004). This type of system incorporates metrics for analysing board inputs and for ensuring processes are in place to achieve the desired level of board involvement.

Although the goal of this study to assess the nature and extent of board involvement in the context of this industry has been accomplished, additional research is needed to verify these results not only in other closely regulated industries, such as health care, but also in firms operating in non-regulated industries facing different environmental constraints. Also, empirical studies that track board involvement data and organisational performance measures over several time periods will help to shed light on the cause and effect of the board's strategy role in relation to the organisation's performance. Through empirical studies, debates and accounts of successes and failures, board involvement may finally extend beyond the traditional and review levels to the point where the board performs its strategy role in collaboration with senior management.

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